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Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Caps Performance Review for Local Exchange Carriers	)	**CC Docket No. 94-1**

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To: The Commission

REPLY COMMENTS OF THE
TELECOMMUNICATIONS RESELLERS ASSOCIATION

The Telecommunications Resellers Association ("TRA"), by its attorneys and pursuant to Section 1.415 of the Commission's Rules, 47 C.F.R. §1.415, hereby submits its Reply Comments in further response to the Fourth Further Notice of Proposed Rulemaking in this proceeding, FCC 95-406 (released September 27, 1995) ("FNPRM"), and the initial comments filed in this proceeding.

I. INTRODUCTION

In these reply comments, TRA responds to comments addressing the total factor productivity ("TFP") methodology the Commission has proposed to employ in computing the productivity offset, or "X-Factor," upon which the price cap index ("PCI") for local exchange carriers ("LECs") will be based. TRA also responds herein to comments addressing the Commission's proposed use of multiple "X-Factors," at least one of which would not provide for a sharing requirement, as well as the Commission's proposed classification of costs as "exogenous" within its LEC price cap structure.

In its Comments in this matter, TRA urged the Commission to reevaluate its tentative conclusion that the LEC "X-Factor" should be calculated using a TFP methodology.

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TRA reasoned that because LEC productivity in providing interstate access services exceeds LEC productivity in the provision of all services,[1] use of a TFP-based "X-Factor" would produce artificially high interstate access charges, wholly unreflective of actual economic conditions. TRA further urged the Commission to retain as a backstop mechanism for the "X-Factor" a sharing obligation for price cap LECs electing the low-end productivity factor, but opposed varying the "X-Factor" to account for emerging competition. Non-LEC commenters were virtually unanimous in their support of the positions espoused by TRA in its Comments.

II. ARGUMENT

A. The Vast Majority Of Non-LEC Commenters Agree That The Commission Should Not Adopt A TFP Methodology For Computing The LEC "X-Factor"

Virtually all non-LEC commenters are in accord that the Commission should not adopt a TFP methodology for computing the LEC productivity offset because the "X-Factor" produced by such a model would not drive interstate access charges toward economic cost. Like TRA, these commenters have shown that an "X-Factor" computed using a TFP method would fail to achieve the three goals established by the Commission for the LEC price caps productivity offset: (i) provide a reliable measure of the extent to which changes in LEC unit costs have been lower than the level of inflation; (ii) ensure that reductions in LEC unit costs are passed through to subscribers, and (iii) reflect a reasonably simple calculation utilizing accessible and verifiable data.[2]

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[1] Comments of AT&T Corp. (filed Jan. 11, 1996) ("AT&T Comments")at 14.

[2] *See, e.g.*, Comments of MCI Telecommunications Corporation (filed Jan. 11, 1996) ("MCI Comments") at 9-11; Comments of the Ad Hoc Telecommunications Users Committee (filed Jan. 16, 1996) ("Ad Hoc Comments"), Attachment, "Establishing the X-Factor for the FCC Long-Term LEC Price Cap Plan", at 5-7; AT&T Comments at 8-10.

The record is now clear that the proposed TFP methodology would not generate economically meaningful results, thereby failing to achieve the Commission's first stated goal. By way of illustration, the TFP model draws no distinction between interstate and intrastate services. Because productivity for interstate services has increased faster than productivity for all services due to the more rapid growth in demand for the former, use of total company data rather than data reflecting only interstate usage would understate the productivity offset.[3/] Different mixes of inputs in the provision of interstate and intrastate services also produce differences between intrastate and interstate productivity that should be reflected in the LEC "X-Factor." For example, as MCI notes, local service requires more customer service resources to serve all of an LEC's end user customers than exchange access service with its fewer, more sophisticated interexchange carrier ("IXC") customers.[4/]

In addition, the TFP methodology incorrectly assumes that changes in input prices for LECs are no different from those for the U.S. economy as a whole. As noted by AT&T, the Commission itself found an average annual input price differential between the LECs and the national economy of 2.23 percent over the period 1984-1992.[5/] The United States Telephone Association ("USTA") notes that over the period 1948-1992, the differential was 0.1 % and concludes on this basis that no price differential exists over the long run. Price differentials averaged over a 44 year period, however, do not adequately capture the impact of the profound changes unique to the local telecommunications sector that have occurred during the last eight

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[3/] *See, e.g.*, AT&T Comments at 14.

[4/] MCI Comments at 8.

[5/] Price Cap Performance Review for Local Exchange Carriers, 10 FCC Rcd. 8962 (1995) ("First Report and Order"), Appendix F at 9213.

of these 44 years and which may continue for the foreseeable future to cause input prices for LECs to grow at a different rate than for the national economy.

The Commission has previously concluded that an "X-Factor" of 3.3% inadequately reflects LEC productivity.[6] Indeed, the Commission adjusted its initial "X-Factor" upward to encompass a range of three productivity offsets extending from 4.0% to 5.3%. Not surprisingly, the majority of the LECs could afford to, and did, opt for the highest "X-Factor" to avoid the sharing obligations associated with the lower values. Yet, the "X-Factors" computed by USTA both under its original[7] and its revised TFP methodologies[8] are all significantly below 3.3%. Studies which calculate the productivity offset on the basis of interstate productivity alone have produced "X-Factors" that range from 7.3% to 9.9%.[9]

To the extent that an "X-Factor" understates LEC productivity, it follows that the model from which the factor was derived would fail to meet the Commission's second criterion. Obviously, an artificially low productivity offset would not ensure that consumers benefit from LEC unit cost reductions.[10] Instead, an artificially low productivity offset would secure for the LECs windfalls equal to the difference between the stated and the true "X-Factor."

The proposed TFP model also fails to satisfy the Commission's third criterion that calculation of the "X-factor" should be reasonably simple and based on accessible and verifiable data. Several commenters have shown that portions of the data used in the TFP model are not

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6/ First Report and Order at ¶ 19.

7/ Id at ¶132.

8/ Comments of the United States Telephone Association (filed Jan.16, 1996) ("USTA Comments") at 3.

9/ *See, e.g.*, AT&T Comments at 25, 29; Ad Hoc Comments at 6.

10/ *See, e.g.*, MCI Comments at 10.

publicly available.[11] USTA has attempted to remedy this problem by revising the measures of change in productivity to rely on inputs and outputs that are not proprietary.[12] While this is a positive development, USTA's action leaves wholly unaddressed concerns raised by other commenters that the TFP methodology is essentially unauditable because methods and procedures used therein to calculate the "X-Factor" have not been fully disclosed.[13]

TRA agrees with other commenters that the TFP methodology requires too much "reinvention of the wheel" in its use of data. For example, the Commission has already developed cost of capital and depreciation rates for LECs.[14] Yet, the TFP model draws on new cost of capital and depreciation proxies which not only would impose additional administrative burdens, but which are inferior to data already available. Although USTA has now revised its cost of capital data to reflect both debt and equity, USTA is now using data reflective of the economy as a whole rather than the LECs alone.[15] The Commission's cost of capital data would clearly provide a more economically meaningful input in calculating an LEC price cap productivity factor than the data proposed by USTA.

Reliance on total company, rather than interstate, data contravenes Section 2(b) of the Communications Act, 47 U.S.C. §152(b), as well as pertinent caselaw, including the landmark Supreme Court decision Smith v. Illinois Bell Telephone Co., 282 U.S. 133 (1930).[16] Section 2(b) fences off from Commission jurisdiction "charges, classifications, services, facilities, or

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[11] *See, e.g.*, MCI Comments at 10; Ad Hoc Comments at 4.

[12] USTA Comments at 14-27.

[13] *See, e.g.*, AT&T Comments at 10.

[14] *See, e.g.*, MCI Comments at 17.

[15] USTA Comments at 17.

[16] Ad Hoc Comments at 6; AT&T Comments at 15 -17.

regulations, for or in connection intrastate communications service." Smith v. Illinois clearly establishes that in regulating rates and charges, the Commission must undertake reasonable measures to apportion costs and revenues between the interstate and intrastate jurisdictions.[17/] "While difficulty in making an exact apportionment of the property is apparent, and extreme nicety is not required," reasonable jurisdictional allocations are mandated to avoid unlawful rates.[18/] Indeed, the Commission itself has acknowledged that "[i]f a LEC's productivity for interstate services differs significantly from its productivity for intrastate services, it may be necessary to rely on separated costs to ensure that interstate rates remain just and reasonable."[19/]

The record confirms that alternative means of computing the LEC price cap productivity offset exist which separate the LECs' interstate productivity growth from the productivity growth for the LECs' intrastate and local services. AT&T, for example, has developed a performance-based model to calculate the "X-Factor" that not only relies exclusively on interstate data, but data that is public available and auditable.[20/] The Commission must explore such alternatives and should adopt an "X-Factor" model that more accurately reflects LEC interstate productivity than does the TFP methodology. Clearly, based on existing law, the Commission cannot rely on a TFP model that fails to allocate costs and revenues among the federal and state jurisdictions.

17/ 282 U.S. 133 at 150-51.

18/ Id.

19/ FNPRM at ¶63

20/ AT&T Comments at 27-29.

B. The Commission Should Adopt Measures To Ensure That Interstate Services Are Priced Close To Economic Cost

Other commenters agree with TRA that various actions should be taken to ensure that past and future reductions in LEC unit costs are reflected in lower interstate access charges.[21] In its Comments, TRA argued that if the Commission were to elect to utilize a TFP methodology to compute the LEC "X-Factor," it should first reduce current access charges to economic cost and then incorporate mechanisms that would ensure that the existing gulf between rates and costs does not reemerge. MCI similarly suggests that the Commission take all actions necessary to drive rates toward economic costs, including the performance of economic cost studies to establish benchmark rates in the event that the Commission adopts a TFP methodology.[22]

Likewise, other commenters have joined TRA in opposing "moving averages" for updating the LEC price cap "X-Factor."[23] As TRA argued in its Comments, moving averages are only reflective of LEC decisions to cut costs; they do not provide incentives for LECs to cut costs to mirror economic costs. Worse yet, moving averages actually provide incentives to selectively increase costs to reduce short-run productivity measures.[24] Moving averages also impose greater administrative burdens than stable "X-Factors" because they necessitate annual recalculation and review of productivity offsets. Recognizing that adjustments would invariably be necessary, TRA, however, joins with other commenters who have objected to the use of moving averages in supporting periodic updating of the LEC productivity offset. Periodic

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[21] *See, e.g.*, MCI Comments at 11.

[22] Id. at 13-14.

[23] *See, e.g.*, Comments of International Communications Association (filed Jan. 16, 1996) ("ICA Comments") at 9.

[24] *See, e.g.*, AT&T Comments at 33-34; ICA Comments at 9.

updates should be easier to administer than moving averages and should better balance the benefits of stability against the benefits of precision.[25/]

TRA also supports retention of the consumer productivity dividend. As argued by AT&T, given that all "X-Factor" methodologies incorporate data drawn from the period preceding price cap regulation and hence reflect productivity growth from the pre-price cap era, the consumer productivity dividend is necessary to account for the gains in productivity price cap regulation is supposed to achieve.[26/] TRA agrees with AT&T that there will be additional opportunities for the LECs to increase productivity in the future -- increases which should result in reduction of rates to the consumer.[27/]

C. The Majority Of Non-LEC Commenters Support Retention Of A Sharing Mechanisms

The large majority of non-LEC commenters, and at least one LEC commentor,[28/] agree with TRA that some form of sharing mechanism must be retained. Commenters generally agree with the Commission and TRA that sharing compensates for imperfections in the "X-Factor." As Ad Hoc notes, given that specification of the "X-Factor" is far from certain and that productivity rates will invariably vary from carrier to carrier, sharing is necessary to adequately protect ratepayers.[29/] As MCI points out, sharing also permits correction for the use of historical

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25/ *See, e.g.*, MCI Comments at 14-17.

26/ AT&T Comments at 35.

27/ Id. at 35-36.

28/ *See, e.g.*, Comments of Lincoln Telephone and Telegraph Company (filed Jan. 11, 1996) ("Lincoln Comments") at 15.

29/ Ad Hoc Comments at 7.

data to predict future productivity and ensures that ratepayers will benefit from future productivity gains.[30/]

TRA agrees that use of multiple productivity offsets is appropriate and supports the consensus of MCI and AT&T that there should be two "X-Factors."[31/] Multiple factors with appropriate sharing mechanisms encourage those whose productivity is above average to continue to enhance productivity. However, TRA agrees with AT&T that low end adjustments could be discontinued. Such adjustments have not proven necessary and have been misused in the past.[32/]

Once a particular productivity offset is selected, an LEC must not be permitted to change from one factor to another. TRA agrees with the numerous parties that have suggested that such changes would permit LECs to "game" the system. As one commenter suggests, if shifting back and forth between "X-Factors" is permitted, the LEC could load expenses into a lower factor year and reap the benefits in a higher factor year, particularly if there is no sharing obligation.[33/]

D. The Commission Should Limit Exogenous Cost Changes To Those Caused By Jurisdictional Shifts

TRA agrees with those commenters that have argued that only those cost changes created by jurisdictional shifts -- e.g., reallocation of costs between the interstate and intrastate or the interstate and intrastate arenas -- should be treated as "exogenous" for price cap purposes.

[30/] MCI Comments at 21.

[31/] MCI Comments at 21; AT&T Comments at 30-33. AT&T has proposed a baseline factor of 7.8% and a higher factor of 8.8%. Sharing obligations would be eliminated for the higher factor. AT&T Comments at 39. TRA would support removal of the sharing obligation for the higher factor if the difference between the two exceeds one percentage point.

[32/] AT&T Comments at 39-40.

[33/] MCI Comments at 22.

Most other changes are either avoidable or evidence an element of voluntary action. As described by MCI:

> Any other change, such as tax and accounting changes, will have their effect on the company primarily because of management decisions to provide service using a certain mix of inputs. Non-regulated companies must determine how to meet these other changes without being able to change their prices, and price cap regulation should mirror this effect of the competitive market.[34]

As MCI notes, it is certainly more appropriate that risk, including the risk of regulation, be borne by shareholders rather than ratepayers because it is they that will reap the benefits when the company performs well.[35] Moreover, the fewer the exogenous cost adjustments, the fewer the disputes and the lesser the drain on administrative resources necessary to adjudicate disputes.

III. CONCLUSION

By reason of the foregoing and the arguments set forth in its Comments, TRA urges the Commission to modify its LEC price cap regime in accordance with the views set forth herein and in TRA's Comments.

Respectfully submitted,

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[34] MCI Comments at 25.

[35] Id. at 25-26.